INVITATION TO ECONOMICS
THIRD EDITION
Teacher’s Annotated Edition

Texas Edition:
complete with Texas Essential Elements
Every nation has an economic system for dealing with the problem of scarcity and, thus, for answering the four economic questions. No two economic systems are exactly alike. In spite of the differences among economic systems, there are many similarities. Among industrialized nations, economic systems are principally a mixture of two “pure” systems—the command and the market. In a pure command system, all economic decisions would be made by government. In a pure market system, all economic decisions would be made through the interaction of buyers and sellers in the marketplace.

In the real world, there are no pure command or pure market systems. It is useful to describe these imaginary systems, however. We can think of them as opposite ends of a continuum and of all real economies as lying somewhere in between.

In this chapter you will learn about the characteristics of a pure market system. These characteristics were first described by the English philosopher Adam Smith in 1776 in his famous book, *The Wealth of Nations*. You will then read about how the market system works in the United States today.
1. Pure market systems have five characteristics.

Economic freedom, economic incentives, competitive markets, private property, and limited government are all characteristics of a pure market system. Each of these characteristics is discussed in the following section.

Find answers to the following questions when reading about the characteristics of pure market systems:
1. What does economic freedom mean?
2. How do economic incentives help people?
3. What is expressed through competitive markets?
4. How do people treat private and public property?
5. What is the government’s role in a pure market system?

Economic freedom means that people are free to make choices.

Most Americans are familiar with the freedoms of speech, the press, and religion. Another kind of freedom is economic freedom. This freedom is a basic characteristic of a market system. Economic freedom means that consumers and producers are free to make certain kinds of choices.

■ Freedom of enterprise. For the man or woman who wants to start a business, economic freedom means the opportunity to decide what product to make, which resources to buy, what production techniques to use, how to market the product, and what price to charge. Imagine the following situation. If Ben Jacobs wants to produce slide rules (tools for mathematical calculations) in a market economy, the freedom to do so exists. He can make the slide rules of wood, plastic, or any other material he wants to use. He can advertise in newspapers and magazines, on billboards, on radio and television, or simply by word of mouth. He can sell the slide rules strictly to friends, in a local market, or on a national scale. He can set the price at $100 or 10¢. In a market system, these decisions are made by individual producers rather than by central government authorities.

Economic freedom does not guarantee success for a business owner. The slide rules may be of high quality and may be worth every cent the manufacturer charges, but consumers do not have to buy them. In this day of advanced computer technology, consumers may prefer a $20 pocket calculator. A business can offer a product for sale, but consumers do not have to buy it.

■ Freedom for consumers and workers. In a market economy, people are free to decide what kind of job to seek and what salary to accept. The money the person earns can be used to buy food, clothes, housing, entertainment, and transportation in whatever combination he or she chooses.
Just as there are no guarantees for the business owner in a market economy, there are no guarantees for the consumer or the worker. After purchasing a car, the new owner may decide that a different model would have been a better choice. If one job doesn't work out, a person can look for another. In a market system, people are free to choose what they think is in their own best interest as long as their decisions do not interfere with the rights of others.

Viewed separately, the decisions to produce slide rules or pocket calculators, to cook at home or to eat out, to be a clerk or a plumber, may not seem important to the economy as a whole, but they are. Freedom to decide ultimately determines how the whole economy will answer the four economic questions.

**Economic incentives help in guiding economic decisions.**
Incentives are rewards and punishments that encourage certain actions and discourage others. Adults praise children to encourage them to take out the trash, wash dishes, or make their beds. Police officers give traffic tickets to discourage people from speeding. Economic incentives are a second characteristic of market systems. Like other types of stimuli, economic incentives can be either positive (rewards) or negative (punishments).

- **Positive and negative incentives.** Positive economic incentives include profits, wages, promotions, and pleasant working conditions. The business that makes products people want, at a price they are willing to pay, should make a profit. A person who does a job that is in great demand will probably receive a high wage.

  Negative economic incentives work in the opposite way. The company that produces slide rules for $100 each is likely to lose money. Twenty-five years ago, slide rules were the cheapest and easiest way to make quick mathematical calculations. Today inexpensive pocket calculators are quicker, perform a wider variety of calculations, and are easier to operate.

  Negative incentives also affect workers. The person who offers to work as a clerk for $20 an hour will probably stay unemployed. Too many other people are willing to do the same job for less money. The person can agree to work for less or try to find another job that pays $20 an hour.

  History provides many examples of how negative incentives affect the decisions of workers. At the turn of the century, many men worked as blacksmiths. As the automobile became popular, the need for blacksmiths' services began to decline and so did their earnings. Many blacksmiths gradually switched to other occupations.

- **Incentives and resources.** In a market system, economic incentives help guide resources into the production of the goods and services that people want most and away from the things they do not want. How does this happen? The economic incentives indicate which actions will be rewarded and which will not. Individuals then act in a way that will bring them the rewards they want. For example, business owners are rewarded by making products that bring in a profit. It is not in their best interest to make a product that loses money. Which products earn profits? The products people want most. So, it is in the best interest of business owners to make products people want.
**Competitive markets are the means through which people express choices.**

Economic freedom and economic incentives can be seen in operation in the competitive markets of a market system. **Competitive markets** are a third characteristic of market systems.

- **The nature of competition.** At the heart of competitive markets are voluntary exchanges. It is through these exchanges that consumers and producers exercise their economic freedom. These exchanges operate simply. When people own property, they can decide when and under what conditions ownership is transferred to another person. To do this, the owner offers the item for sale. Prospective buyers look it over and consider the terms of trade. If both the buyer and seller feel they will benefit, the exchange is made.

  In a market system, then, people make their wants and needs known by the purchases they make. When they buy an item, they are casting their vote for the good or service they want. For example, if Carol Murphy regularly buys a cheeseburger for lunch at Hamburger Heaven, she is telling Hamburger Heaven that she likes what they are doing for the price they are charging.

  The owner of May’s Diner has several options open to her if she wants Carol Murphy’s business. She can try to make a cheeseburger of equal quality to the one sold at Hamburger Heaven, she can lower her price, or she can improve her service.

  Of course, it is unlikely that May’s Diner is going to respond solely to what Carol Murphy does. After all, Murphy is not the only person eating out. In a market economy, it is through millions and millions of voluntary exchanges that people make their overall preferences known.

  When enough people buy a particular product, the company producing that item will earn a profit. (This assumes, of course, that the company has set a price that covers the cost of production and allows for profit as well.) The company will stay in business, perhaps even expand, and continue to make the product as long as people are willing to buy it. In contrast, if too few people buy a product, the company producing it will lose money. This loss is a signal to the management of the company to make some changes. If the losses continue, the company will eventually go out of business.

- **The benefits of competition.** In most political elections, there is only one winner—the candidate with the most votes. If the economic system operated under the same principle, everyone who drinks soda pop would be drinking Coca-Cola because it is currently the biggest seller (“winner”) in its market. In a truly competitive market, each and every consumer should be able to get the product he or she wants. Anyone who does not like Coke can choose from Pepsi, 7-Up, Dr. Pepper, R.C. Cola, Sprite, A & W Root Beer, Tab, or a number of other alternatives.

  One benefit of competition, then, is variety. From time to time, one brand may become more popular than others. When that happens, the leading company will earn larger profits. The other companies, in an effort to improve their positions, will do everything they can to produce a product that consumers will prefer. Variety is the result.
A second benefit of competition has to do with price. As you learned earlier, companies can compete by lowering their prices. For example, at 50¢ a can, some people may prefer Coke to 7-Up. In order to sell more 7-Up, its producers might offer it for sale at a lower price. Of course the price can be lowered only so far. A company must be able to cover its costs and earn a profit. If it does not, investors will switch their money to a company where a profit is being made. The price of the most popular brand of soda is also held down by competition. If Coca-Cola were to raise its price, consumers would probably find other soft drinks more appealing. Competition, then, keeps the price of products as low as possible while still enabling producers to make a profit.

The third way in which competition benefits consumers is by improving products and services. Have you ever bought something because it was cheaper than other brands only to discover that it was poorly made? Did you rush to buy another of the same brand? Probably not. The quality of a product is important to the buyer. A company that makes a product of inferior quality probably will not stay in business very long. Competition tends to keep prices low and quality high.

- The need for information in competitive markets. Information is important to competitive markets. Consumers need to be aware of the choices available when they make decisions. Consumers are like voters in this respect.

People in a democracy enjoy political freedom, but that freedom includes the responsibility to cast an informed vote. Ultimately, responsibility for decisions made by the government lies with the people. Similarly, in a market system, responsibility for economic decisions rests with the people. For this reason consumers should try to be as informed as possible about their buying decisions. When consumers make choices, they encourage manufacturers to make more of the product they choose. If they make poorly informed choices, they may be encouraging producers to put out shoddy goods.

Consumers can get the information they need from many sources. Companies themselves try to make consumers aware of their products through advertising. Other sources of information include newspaper and magazine columnists who rate products. Organizations such as Consumers’ Union test and rate a variety of consumer products so that consumers can be informed when they buy those items.

**People treat private and public property differently.**

The term “property” means more than just a piece of land or a house. It also includes furniture, clothes, food, money, and the public schools. Property is anything that is part of a nation’s wealth.

Under a system of private ownership, private individuals own property. With that ownership go certain privileges, or legal rights. For instance, the owner decides how private property will be used, when to sell the property, and under what terms it will be sold. The owner receives any income or other benefits derived from private property. The owner of a house decides whether to live in it, rent it out to someone else, leave it vacant, or tear it down. If the decision is made to rent a house, the owner decides how much to charge for a deposit and how much the rent will be. Private property is one more characteristic of a market economy.
In contrast with a system of private ownership is a system of public ownership. Under a system of public ownership, property is owned by everyone and decisions about its use are made by all the people together. In practice, it is impossible in a complex society to allow everyone to decide how public property will be used.

Do people treat public and private property in the same way? The answer is simple. Private property is a part of a person’s wealth. Any action that decreases the value of private property diminishes the wealth of the owner. It is part of human nature to want to increase one’s own wealth. Because public property belongs to everyone, few consider it a part of their own wealth. Economists feel these economic incentives help explain why people take better care of private property.

**The role of government is limited in a pure market system.**

There are no pure market economies operating in the world today. Why then try to answer the question “What is government’s role in a pure market economy?” The question of government’s role in the economy in the United States has been long debated, particularly in the twentieth century. Therefore even a theoretical discussion can help us understand the debate as it applies to our own mixed-market system.

In a pure market system, government would not determine the answer to the four basic economic questions. That would be left entirely to people buying and selling in the marketplace. This philosophy of no government interference in economic decision making is known as **laissez-faire**, after the French “allow to do.”

Instead, government would provide the structure or framework within which the four questions were answered and the market system would operate. This involvement, although limited, would be important nevertheless. To provide a structure for the market system, **limited government** would function in three major areas.
Establishing rules. The first function of government in a pure market economy would be to establish the rules of the game. These rules would support the characteristics of a market system. For instance, they would protect private property and ensure the rights of property owners. They would provide the maximum amount of economic freedom. They would protect the rights of both buyers and sellers by making laws against such things as fraud. The government would also encourage competition by making laws against monopolies and against fraud and deceit in business operations. It would not grant special privileges or create restrictions.

Enforcing rules. The second function of government in a pure market economy would be to enforce these laws. Police would assist people in protecting their property. They would make sure no one’s economic freedom was threatened. An agency would exist to carry out the anti-monopoly laws.

Settling disputes. The third function of government in a pure market economy would be to settle any disputes over the interpretation of the rules or the way they were enforced. No matter how clearly laws are written, there are bound to be disagreements about their meaning or their legality. No matter how carefully laws are enforced, there will be instances of improper actions. Anyone who felt he or she had been mistreated could appeal to the courts for a final decision. The government’s role would be somewhat like that of a baseball umpire—to enforce rules and settle disputes between players.

By functioning in the three ways mentioned above, the government would create an atmosphere favorable to voluntary exchanges—an atmosphere in which people could feel that they were being dealt with fairly and honestly. Such an atmosphere is necessary or voluntary exchanges do not take place.

SECTION 1 REVIEW

Key Terms
- economic freedom, economic incentives, profit, competitive markets, voluntary exchange, private ownership, public ownership, laissez-faire, limited government

Reviewing Main Ideas
1. What does economic freedom mean to the consumer, the producer, and the worker?
2. What is the difference between a positive and a negative incentive to business?
3. What effect do competitive markets have on consumers’ choices?
4. In what ways do people treat private property and public property differently?
5. In what three ways is government limited in a pure market economy?

Thinking Critically: Assessing Cause and Effect
As a consumer you are faced by many choices each time you decide to purchase some item. Using the purchase of new clothing as an example, describe how the choices you make result in positive and negative incentives for the producers.
The U.S. economy is mainly a market system.

What terms do people use to refer to the economic system of the United States? Capitalism, free enterprise, and private enterprise are three of the terms frequently used. These are terms with which you are probably familiar. Like all economies in operation, our economy is a mix of command and market systems. Because the economy of the United States is predominantly a market economy, the term **mixed free-enterprise economy** is also used. Let's look at each of the five characteristics of a pure market system as they exist in the United States today.

**Find answers to the following questions when reading about the market system in the U.S. economy:**

1. How does the U.S. government affect economic freedom?
2. How do economic incentives affect the U.S. economy?
3. What limits are placed on a competitive market?
4. What kinds of property in the United States are privately owned?
5. How has government's role in the U.S. economy changed?

**Government affects freedom in a mixed free-enterprise system in a number of ways.**

The United States has always prided itself on the amount of freedom its people cherish and enjoy. This includes not only political and religious freedom but also economic freedom.

In a pure market system, individuals would make all economic decisions. For the most part, this is true in the United States. We decide what jobs we wish to seek, where we want to purchase products, and what products we want to make. The government, however, does play a role in many economic decisions in our mixed free-enterprise economy. For example, the Constitution grants the national government the power to place tariffs, or taxes, on foreign goods. By making the foreign goods more expensive, tariffs encourage people to purchase U.S.-made goods. The Constitution also gives the government the right to tax citizens directly. (See Between the Lines on page 45.) We have indirect control over how this tax money is spent because these decisions are made by our elected representatives, but the control is not as great as the control we exercise over our take-home pay.

Actions by the government affect us in many other ways as well. For example, if we choose to purchase a car, it will have certain safety and pollution-control devices on it that are required by law. A home constructed within the city limits must conform to local building codes. Most workers must join the Social Security system. In spite of the many ways in which government activities affect the economy, however, Americans still enjoy more economic freedom than do people in most countries of the world.
Economic incentives are an important part of the U.S. economy.

Most Americans are familiar with the concepts of profit and loss. People start a business in order to earn a profit. Businesses fail when they lose money. To a large degree, these economic incentives operate in the U.S. economy. You can see profitable businesses operating in your community every day. Those are the ones that have been in business for several years. You can also see boarded up windows and vacant buildings. Those are the ones that have failed.

Again, the United States does not have a pure system in this respect. The government has, on occasion, saved a business that was on the verge of bankruptcy. For example, it guaranteed loans to the Chrysler Corporation in 1980. This was done to keep Chrysler’s workers employed.

Competitive markets may have economic and governmental limitations placed on them.

Competition in a pure market economy is often defined as a large number of producers offering a particular product for sale to a large number of buyers. This ensures that individual buyers and sellers are such a small part of the market that no one seller or buyer can influence the price of the product. This theoretical situation, however, does not often exist in the real world.

There are different degrees of competition in the U.S. economy today, and it is not always easy to draw a clear line between them. However, it is easy to think of industries where a consumer has wider choices than in others. In the fast-food market, consumers have many choices: Pizza Hut, Taco Bell, Kentucky Fried Chicken, and McDonald’s are
only a few of the many options available to consumers. When it comes to buying a car, on the other hand, a consumer’s choice of producers is more limited. In the case of electricity and gas utilities, there is no choice at all.

In some instances there are economic reasons for a fewer number of firms to exist. In the automobile industry, it is much less costly for a few large firms to produce cars than for a large number of small firms to do so. In some cases, as was once so in the airline industry, competition has been reduced as the result of government regulation. Sometimes the government eliminates competition altogether. For example, many feel that it would be a waste of our limited resources to have more than one utility company serving the same area.

**Most property is privately owned in the United States.**

Without a doubt, most property in the United States is privately owned. People own cars, houses, clothes, furniture, and a wide variety of other items. In addition, most businesses are privately owned.

Nonetheless, some property in the United States is publicly owned. Public parks, beaches, highways, firehouses, police stations, and schools are some of the most familiar forms of public property. There are others. These include city halls, courthouses, military bases and equipment, city and county hospitals, government office buildings, and some public housing. In the business world, government ownership is almost nonexistent. The few exceptions include AMTRAK and public utility companies.

**Government’s role in the U.S. economy has changed over time.**

The role of government in the U.S. economy has expanded, particularly since the Great Depression of the 1930s. Look at the diagram in Figure 2-1 on page 42. It shows how the U.S. economy has elements of a pure command economy and a pure market system. The U.S. economy has gained some elements of a command economy since the 1930s. Why has this trend occurred? There are many reasons. Government spending on military equipment has increased during these years, and of course, such spending has an enormous impact on the economy. Americans have also turned more to government to solve the problems of poverty, pollution, unemployment, medical care, inflation, and other such problems during the past 50 years.

As the role of government expands, the characteristics of a pure market system are reduced. Deciding how large a role government should take is something that Americans have done in the past and will continue to do in the future. Because there is much disagreement on the proper role of government, it is the subject of much debate. See the YOU DECIDE feature on pages 76–81.

During his two terms in office, President Ronald Reagan promised to reverse the trend of increased government involvement in the U.S. economy. As with the debate over the role of government, the likelihood of President Reagan’s success has been the subject of disagreement. It is unlikely that his success or failure will be seen clearly for some time. The reason is because some economic decisions take a long time to have a visible effect.
**Figure 2-1** THE U.S. ECONOMY—PAST AND PRESENT

As the scale below shows, the U.S. economy is primarily a market economy. Like all economies in operation, however, it is a mixture of command and market forces. In the past 50 years, more elements of command have been added to the economy.

**Question**
How does the balance scale below show that the U.S. economy is primarily a market economy?

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**SECTION 2 REVIEW**

**Key Terms**
mixed free-enterprise economy

**Reviewing Main Ideas**

1. What are some areas in which government actions affect our mixed free-enterprise system?
2. How do economic incentives operate in the U.S. economy?
3. Are all sections of the U.S. economy equally competitive? Explain.
4. What are some examples of private property in the United States? What are some examples of public property?
5. What factors have influenced the trend toward an increased government role in the U.S. economy?
6. As the role of government expands, how are the characteristics of a pure market system affected?

**Thinking Critically: Assessing Cause and Effect**
The government’s role in the economy directly or indirectly affects many of the goods and services you buy. Think of three specific ways in which the government’s role in the U.S. economy affects your choices as a consumer.
The circular flow model can be used to study the market system.

The workings of a market economy are complex, involving the interaction of various economic forces. To simplify the study of the market system, economists have developed a simple model, the circular flow chart. Look at Figure 2–2 on page 44 to see an example of a circular flow chart. This diagram presents an overview of the market system. It is an economic model and is not meant to be a perfect representation of the economic forces that operate in the real world. Although a market economy is more complex than this simple picture indicates, the circular flow chart can still be used to gain insight into how a market economy works.

The chart is divided into two sectors—households and firms. The households represent the individuals in society. They own the resources, or factors of production. The firms are the businesses that produce the goods and services that consumers buy.

Find answers to the following questions when reading about economic forces in a market economy:

1. In what areas in a market system do voluntary exchanges take place?
2. What do NI and GNP measure?

In a market system, voluntary exchanges take place in two areas.

In a market system, voluntary exchanges continually take place. In the circular flow model, they occur in two separate markets, the factor market and the product market.

- **Factor market.** In the factor market, the owners of the factors of production (the households) sell those factors of production to the firms. In exchange the households receive money in the form of wages, rent, and interest. The arrows that pass through the factor market represent these transactions.

  It is interesting to note that in the factor market, the households are the sellers and the firms are the buyers. We are not accustomed to viewing ourselves as sellers. We just naturally refer to ourselves as consumers, or buyers, and to businesses as producers, or sellers. As Figure 2–2 on page 44 shows, however, households are not always buyers, and firms are not always sellers. The role of households and firms depends on the market they are in.

- **Product market.** In the product market, firms sell the goods and services they have produced to the households. This time the money flows from the households to the firms. Once again, two arrows show these exchanges.

NI and GNP are two measures of economic activity.

The arrows in the circular flow model represent the nation’s economic activity. Economists use two statistics as a rough measure of the size of this activity.
Figure 2-2  CIRCULAR FLOW CHART

As the circular flow chart below shows, in the product market, firms are the sellers and households are the buyers. In the factor market, households are the sellers and firms are the buyers.

Questions
1. Describe some of the factors of production that households sell in the factor market.
2. What do firms sell to households in the product market?

National Income. National Income (NI) is a measure commonly used to gauge the amount of money flowing from the firms to the households in the factor market. NI includes wages and salaries as well as corporate profits, interest, and rent.

Gross National Product. Gross National Product (GNP) is used as a measure of the dollar value of goods and services produced by the economy in the product market. In computing the GNP, economists include only the value of the final goods and services produced. If they did not, a problem would result. For example, if the sale price of a house as well as the value of the lumber, bricks, glass, and cement used to make it were all included, the total would be greatly exaggerated. For this reason an attempt is made to include only the value of final goods and services produced—in this case, the house. The total calculated in this manner is called nominal GNP.
There is also another difficulty that economists must deal with when figuring GNP. What happens when the prices of products change from year to year? If the price of all goods and services doubled from one year to the next while the amount of each product made stayed the same, the nation's nominal GNP would double. Those nominal GNP figures would give an incorrect impression of what had happened. Economists, therefore, make adjustments for changes in prices. The resulting figure is called real GNP.

Although the circular flow model presents an incomplete picture of a market economy, it is a good place to start. The next chapter will take a closer look at the various ways firms are organized. Unit 2 will focus on how the forces of supply and demand operate in the factor and product markets. Unit 3 concentrates on the role of money, banks, and the Federal Reserve System in our economy. The government's role in the economy will be described in Unit 4. Each step adds further realism to the simple circular flow model described in this chapter.

**Between the Lines**

**Tax-Freedom Day**

How much of the average worker's salary goes toward paying taxes? Suppose you started paying taxes to the government out of the money you earn beginning on January 1. You do this until you have paid the federal, state, and local governments all the taxes you owe for that year. The day on which you have paid all of your taxes and begin to keep your income for yourself is called Tax-Freedom Day.

For the average taxpayer in 1930, Tax-Freedom Day occurred on February 13. (See Table 2-1 below.) Since then, as government spending increased, more money had to be collected in taxes. Therefore, Tax-Freedom Day arrived a little later in each succeeding year. In 1940, for instance, tax-payers worked until March 8 to pay off their taxes. Each year between 1940 and 1981, Tax-Freedom Day arrived a little later in the year. Since 1982, however, Tax-Freedom Day has been arriving earlier in the year.

Another way to calculate the amount of the average salary that goes toward paying taxes is to figure out how much of an eight-hour workday is used to earn money for paying taxes. In 1985 one hour and 43 minutes went to the federal government and 55 minutes to state and local governments. (See Figure 2-3 below.) This compares to 21 minutes to pay for clothing and one hour and 34 minutes to pay for housing and household costs.

<table>
<thead>
<tr>
<th>Year</th>
<th>Tax-Freedom Day</th>
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<tbody>
<tr>
<td>1930</td>
<td>February 13</td>
</tr>
<tr>
<td>1940</td>
<td>March 8</td>
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<td>1950</td>
<td>April 3</td>
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<td>1960</td>
<td>April 17</td>
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<td>1970</td>
<td>April 28</td>
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<td>1980</td>
<td>May 4</td>
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<td>1981</td>
<td>May 6</td>
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<td>1982</td>
<td>May 4</td>
</tr>
<tr>
<td>1983</td>
<td>May 1</td>
</tr>
<tr>
<td>1984</td>
<td>April 29</td>
</tr>
<tr>
<td>1985</td>
<td>April 30</td>
</tr>
</tbody>
</table>

**Figure 2-3 TAX BITE IN THE EIGHT-HOUR DAY**

- **Food and tobacco**: 59 min.
- **Clothing**: 21 min.
- **State and local taxes**: 35 min.
- **Transportation**: 42 min.
- **All other**: 51 min.

- **Federal taxes**: 1 hr. 43 min.
- **Recreation**: 20 min.
- **Housing and household operation**: 1 hr. 34 min.
- **Medical care**: 35 min.
Unemployed factory workers in San Antonio, Texas. Being laid off will not only disrupt these workers' lives, it will also lower the national income.

**SECTION 3 REVIEW**

**Key Terms**
circular flow chart, households, firms, factor market, product market, National Income, Gross National Product, nominal GNP, real GNP

**Reviewing Main Ideas**
1. In what two markets do voluntary exchanges take place?
2. Using the circular flow diagram, give a general explanation of how a market system operates.
4. What is the difference between nominal GNP and real GNP?

**Thinking Critically: Assessing Cause and Effect**
If you have a part-time job after school or on the weekend, how are you participating in the circular flow of goods and services? Whom are you affecting by your participation and how?
Making Economic Decisions

Imagine yourself, as an adult, in each of the following situations:
- You answer the phone. A salesperson offers you a chance to invest in a new gold stock, promising that "You'll double your money in a year." Would you (a) buy the stock, (b) ask her to provide you with written material about the stock, or (c) refuse her offer?
- You are visiting new car showrooms before deciding which car to buy. A salesperson states that "The manager will allow me to give you a great price on this car, but only if you'll sign the papers today." Would you (a) reach for a pen, (b) tell the salesperson that you'll think about it, or (c) decline the offer?
- The doorbell rings. A man in coveralls says, "I'm painting your neighbor's house. I'll give you a reduced rate if you'll have your house painted now while my equipment is in the area." Your house does need to be painted. Would you (a) immediately accept the offer, (b) tell him you'll have to get several estimates, or (c) tell him you're not interested.

Choice "a" in each situation above is called for an immediate decision. Such decisions often lead to mistakes that were unforeseen at the moment of making the decision. Every day, people make hasty economic choices such as those described in the examples, and often regret making them quickly.

The ability to make appropriate economic decisions is an essential skill that you will need throughout your life. You can improve your decision-making skills by learning a procedure for making choices. The process is applicable to any economic problem. Using the decision-making process to deal with economic problems will help prepare you to deal with the numerous economic choices you will make throughout your life.

Table 2-2 on this page illustrates the basic steps in the process. Study the chart below, then read the detailed explanation of the decision-making process and complete the activities at the end of this section.

The Decision-Making Process.
- Step 1: State the decision to be made. Because every economic decision is a problem you must solve, phrase each issue in the form of a question. "Is

<table>
<thead>
<tr>
<th>Table 2-2</th>
<th>MAKING ECONOMIC DECISIONS</th>
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<tbody>
<tr>
<td>Step 1:</td>
<td>State the decision to be made.</td>
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<td>Step 2:</td>
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<td>Evaluate the decision.</td>
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it worthwhile to repair my stereo?”

“How much rent can I afford in college when I will also have to pay tuition?”

Asking a question will focus your attention on the task ahead and will point the way toward finding a solution.

Avoid phrasing the question so as to predetermine your answer. Do not ask yourself, for example, “Which graphite tennis racket should I buy?” if the real issue is “Can I afford a new racket?”

When faced with a difficult and complex decision, you may find it helpful to separate the problem into its component parts. Consider a problem that you will face in a few years: buying a car. Break the decision into several parts and arrange these in a logical order.

1. Should I buy a car?
2. How much can I afford to spend?
3. Should I buy a new or a used car?
4. Which car should I buy?

Only if you answer “yes” to Question 1 can you expend time and energy on dealing with the remaining issues.

■ Step 2: Gather information.

Gather your information by doing research, drawing on your own experiences, and consulting family members, friends, and experts.

Assume you have reached the stage of deciding which used car to buy for $1,800. You might use the magazine Consumer Reports to check the repair records of various models, scan the want ads to get some sense of prices, talk to your parents about the costs of car ownership, and ask an auto mechanic about the ease of repair of different cars.

In gathering data, it is best to consider all sources of information. Information that might contradict your desires should be considered. You may, for example, be attracted to convertibles. However, this emotional attraction should not blind you to the fact that convertibles are less safe, are costly to insure, and may not meet with your parents’ approval.

Place realistic limits on the amount of time you spend on this step. Your time investment should be proportionate to the amount of importance you attach to the decision. If a car is more important to you than a stereo, you should spend more time on the purchase of a car than on the selection of a stereo.

Finally, you may have to modify your question as a result of your research. Comparing the price of dealer and private-party autos may lead you to change your question to “What car can I buy from a private party for $1,800?”

■ Step 3: Identify alternative courses of action. When you have completed Step 2, it is time to propose solutions. Limit your potential solutions to those that are realistic and viable.

Let’s return to the example that was used—the purchase of a used car for $1,800. Three possible options might be:

Option A: a 1967 six-cylinder Ford Mustang

Option B: a 1980 four-cylinder Honda Civic

Option C: a 1978 eight-cylinder Oldsmobile Cutlass

All three cars are presently running well and are in good condition.

■ Step 4: Evaluate the consequences of each action. Now you must evaluate each option, weighing the “pros” and “cons” of each choice. Do this by selecting some criteria by which the positive and negative features of each choice can be measured. In purchasing a car, these might include durability, size, gas mileage, style, frequency and ease of repair, and the reactions of parents and friends. Your evaluation would look something like the one that follows, although it could certainly differ.
Option A: pro—stylish, has status with friends, good mileage, good size, good repair record, easy to repair by myself. con—old, most likely to require major work, parents would not approve.

Option B: pro—excellent gas mileage, excellent repair record, newest, parents would approve. con—small, not stylish, fairly difficult to repair by myself, could be dangerous in an accident, friends would not be impressed.

Option C: pro—good size, fairly new, some style, friends would approve. con—low gas mileage, difficult to repair by myself, repair record only fair, parents would feel it is too powerful.

At this point you may want to use an important tool that economists use to study economic decision making. This is the comparison of costs and benefits, or marginal analysis. Marginal analysis helps you to make decisions by identifying the consequences of small changes in a situation.

An example of marginal analysis is the way you might select optional features on a car. Suppose you were considering buying a car from a dealer who offered you several optional features at additional prices.

First, you would examine the benefits of adding extra features to the car. For example, if you add an AM/FM radio and an interior trunk release, you could listen to music in the car and open the trunk from inside the car. Driving the car would probably be both more enjoyable and convenient.

Next, you would examine the costs of adding these options. They might cost an extra $100 to $200, which you would have to pay for by working extra hours at your job, by borrowing money from your parents, or by taking more money from your savings. Your decision about whether to select some optional features for your car would depend upon whether you felt that the benefits of the options outweighed the costs. If they did, you would select the options. If the costs outweighed the benefits, you would decide not to purchase any extra options.

Step 5: Make a decision. At this point it is time to act. It is only now that your personal preferences should enter the decision-making process, because the choice you make will be influenced by your values. If style and status are important to you, you may choose Option A. If low costs and the approval of your parents are important values, Option B might be selected.

Step 6: Evaluate your decision. You can only improve your skill at making economic decisions by evaluating your actions. Ask yourself if you made a good decision. If you decide you didn’t, determine where you went wrong. Did you ignore facts that did not support your desires? Did you act too quickly? Did you ignore the advice of an expert?

By analyzing a good decision or identifying the error in a wrong decision, you will help ensure a wiser decision the next time. Although this six-step process takes time and effort, it is worthwhile. Remember, it is easier to make an intelligent decision than it is to correct the effects of a foolish one.

Applying Your Skills.
1. Which of the three cars described in the example above would you have selected? What values influenced your decision?
2. Give three possible sources of information for each of the following:
   a. buying a stereo, records, tapes;
   b. selecting a college;
   c. decorating your room;
   d. attending a school dance.
3. Your parents want you to select your own graduation present. They would like you to select a single item that costs no more than $100. List three possible options and the pros and cons of each choice. Then write which item you would select and the values that led to your decision.

Answers to Applying Your Skills:
AVS 4J 1. Student answers will vary.
   CON 10 2. Student answers will vary but possible answers include: a. Consumer Reports, a knowledgeable friend, a person who sells stereo, b. a school counselor, college catalogs, alumni of various colleges, c. a library book, someone who has recently purchased a home; d. classmates, friends, parents.
   AVS 4J 3. Student answers will vary.
CHAPTER 2

REVIEW

SECTION SUMMARIES

1 Pure market systems have five characteristics.
Economic freedom is a basic characteristic of a pure market economy. Consumers, workers, and businesses are able to choose what is in their own best interest. Another characteristic is economic incentives. Both positive (rewards) and negative (punishments) incentives exist. These incentives encourage producers to use resources to make goods that people want and discourage them from making goods that people do not want. A third characteristic is competitive markets. Competition results in lower prices, in higher quality, and in a greater variety of goods and services. A fourth characteristic is the private ownership of property. A fifth characteristic is a limited role for government.

2 The U.S. economy is mainly a market system.
The U.S. economy today is a mixed free-enterprise system. Taxes, tariffs, and safety regulations are examples of ways government affects economic freedom. Both positive and negative incentives operate in the U.S. economy today. Most markets in the United States are competitive. The government owns some property and businesses, such as courthouses, roads, and the postal system. Most property in the United States, however, is privately owned. Since the 1930s, the government’s influence over the economy has changed, generally increasing in scope.

3 The circular flow model can be used to study the market system.
A circular flow chart presents an overview of a market economy. In the factor market, households sell the factors of production to firms. In return the households receive wages, rent, profit, and interest. The total amount of money flowing from the firms to the households is called National Income (NI). In the product market, firms sell the goods and services they have produced to the households. The total value of the final goods and services produced by a nation during a year is called Gross National Product (GNP). GNP and NI are rough measures of a nation’s economic activity.

ANSWERS TO ACTIVITIES:

1. Answers will vary. See student charts.
2. Answers will vary. See student lists.

ANSWERS TO BIBLIOGRAPHY:

1. Student answers will vary but should include: The consumer (households) determines what is purchased, setting in motion the production (product market—firms) of the most needed or desired goods and services.
2. Student answers will vary but should include increasing plant size, product diversification, becoming more service-oriented, changing production volume to match consumer demand, price cuts, and rebate offers.

USING ECONOMIC SKILLS

Activities
1. Make a chart showing kinds of businesses that operate in your community. Show changes that firms within each category have made to keep up with their competitors.
2. Make a list of firms in your neighborhood or town that have gone out of business during the last two years. Give one or two reasons that you think might have caused each of the failures.

BIBLIOGRAPHY:

Reading Source Material

**Reviewing the Skill Workshop**
Describe an important economic decision that you made during the past year:
1. State the problem.
2. List the information you used.

**TESTING FOR UNDERSTANDING**

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<td>Define these terms in your own words.</td>
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**Section 1**
- economic freedom
- economic incentives
- profit
- competitive markets
- voluntary exchange
- private ownership
- public ownership
- laissez-faire
- limited government

**Section 2**
- mixed free-enterprise economy
- circular flow chart
- households
- firms
- factor market
- product market
- National Income
- Gross National Product
- nominal GNP
- real GNP

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<tr>
<td>1. In what ways is economic freedom important to the consumer, the producer, and the worker?</td>
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<tr>
<td>2. What is the difference between voluntary and market exchanges?</td>
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<td>3. How are voluntary exchanges central to competitive markets?</td>
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<td>4. What kind of privileges or rights go with private ownership?</td>
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| Section 2 |
| 1. How does government affect economic freedom in a mixed free-enterprise economy? |
| 2. Why are economic incentives important in the United States today? |
| 3. How do government and economic activity limit competitive markets? |
| 4. What kinds of property are publicly owned in the United States today? |
| 5. In what ways do government influence the U.S. economy today? |

**Thinking Critically**

1. **Recognizing Values.** Why can’t economic freedom offer guarantees to either producers or consumers? 
2. **Assessing Cause and Effect.** The U.S. government has, in the past, guaranteed loans to failing businesses. How do you think government loans to failing businesses might affect the economy? 

**Answers to Reviewing the Skill Workshop:**
- AVS 4J 1-5. Student answers will vary depending upon student experiences.

**Answers to Knowing Key Terms:**
- See margin definitions in Chapter 2.

**Answers to Reviewing Main Ideas:**
- The questions under Reviewing Main Ideas cover the main ideas introduced in the Reading Previews and reviewed in the Section Reviews of this chapter. For answers to these questions, see the appropriate Section Review.

**Answers to Thinking Critically:**
- **CON 1B:** 1. Student answers will vary but should show an understanding.
- **AVS 3B:** that economic freedom depends upon voluntary exchanges between producers and consumers and therefore cannot be subject to the market restrictions that guarantees would regulate.

**CON 1E:** 2. Student answers will vary.

**AVS 3I:** Possible answers include: It would set a precedent if the government began bailing out private companies. If the business defaults on the loan, government would have lost its invested money, which might have helped some area of the economy—government would be left owning a private business. The government may bail out failing businesses to prevent the unemployment of thousands of workers.
Visitors to Moscow often notice something unusual about the habits of local automobile drivers. They keep their windshield-wiper blades in the glove compartments of their cars. When it rains, they stop their cars, put the blades on the wipers, and drive off. When it stops raining, the blades go back into the glove compartment. What would cause people to do this?

The five-year plans that determine economic production in the Soviet Union set production quotas in terms of a certain number of tons of parts that are to be produced each month. Because it is easier to meet the monthly quota by producing heavy parts such as engine blocks and bumpers, few lightweight items are produced. The windshield-wiper blades that come with the car are likely to be the only ones that the owner of the car will ever have.

In this chapter you will learn the basic principles of socialism. You will examine some variations of socialism in countries such as the Soviet Union and China and see how economic decisions are made in these systems.
Socialism is based on the idea of equality.

Up to this point, we have concentrated on the market system because it is so important to the U.S. mixed free-enterprise economy. However, the market system is only one way of dealing with the problem of scarcity. Many nations have adopted other systems for answering the four basic questions: What should be produced? How much should be produced? What methods of production should be used? How should the goods and services be distributed? Broadly speaking, a socialist economy is one such system.

Find answers to the following questions when reading about socialism:
1. What were the basic ideas of the early socialists?
2. What belief formed the basis of Karl Marx’s philosophy?

Early socialists proposed new economic and social ideals.
A socialist economy has three basic characteristics: (1) the state owns and operates the major factors of production; (2) central planners determine many of the answers to the four basic economic questions; (3) there is an attempt to distribute income equally. Under capitalism, which is often contrasted with socialism, the factors of production are owned privately. Activities in the marketplace answer the four basic economic questions, and income distribution is determined by interaction between buyers and sellers in the marketplace.

The Industrial Revolution, which began in Europe in the late 1700s, was a time of great economic and social change in many countries. Before the Industrial Revolution, people generally had worked as individuals or in small groups and had produced goods by using simple tools. The Industrial Revolution brought the age of the factory, complex machines, and mass production. This rapid change also brought problems.

As people moved into cities to find jobs in factories, they crowded into areas that had been built for fewer people. Slums developed. Factory work was often dangerous, and fourteen-hour days were the rule. To some nineteenth-century critics, it seemed that workers were not benefiting from their labors as much as the owners of the factories, the capitalists. In reaction to this economic gulf between owners and workers under capitalism, some economic thinkers proposed a socialist system.

One of the major goals of the socialists was economic and social equality. They viewed the differences between workers and factory owners as unjust. To provide for economic justice, some early socialists proposed utopias. Their utopias were ideal communities in which the factors of production were to be owned in common and income would be distributed more or less equally. In some of these communities, everyone would have a voice in government. Communities based on these principles of equality were actually founded. In time, however, almost all of them failed.
Although the model communities did not last, socialist ideas did. In many countries, people worked to accomplish these goals through unions and democratic processes. Most nations, for example, have passed laws to protect their workers. Many nations have also begun programs to raise the standard of living. The progressive income tax, welfare programs, and the resulting income redistribution that is practiced in the United States are applications of socialist ideas. In some countries people worked peacefully within existing economies to bring about changes based on socialist ideals. In others, however, people used force to set up socialist systems.

**Karl Marx urged a replacement of capitalism with communism.**

The movement to overthrow capitalism by force can be traced to the writings of Karl Marx. Born in Prussia in 1818, Marx studied philosophy. He was disturbed by the living conditions of the working class and wrote many articles and pamphlets that urged workers to revolt against the system. In 1848 he and his close friend, Friedrich Engels, a wealthy factory-owner's son, wrote *The Communist Manifesto*. In this manifesto they urged: "Workers of the world, unite! You have nothing to lose but your chains!" Because of Marx's ideas, the governments of three different countries forced him to leave. When he finally settled in England, he continued his career as a revolutionary thinker, and he formulated his own views of socialism.

**Criticism of capitalism.** In his major work, *Das Kapital*, Marx forecast the end of capitalism. He said that it was doomed because it was based on inequality. In capitalism, he said, there were two distinct groups, or classes: capitalists and proletariat, or workers. Because capitalists controlled the factors of production, they could exercise great control over the lives of workers. The capitalists could pay the workers very little and yet sell the products that the workers made at a great profit. According to Marx's theory, the capitalists gained this profit at the expense of the workers. Marx said that because the capitalists had not worked to make these goods, they had not earned the profits.

**Belief in the inevitable struggle.** Marx's ideas about economics were closely related to his view of history. He believed that history consisted mainly of a series of struggles. Early human history, said Marx, had been an ongoing struggle between people and nature. Later, under capitalism and some economic systems that preceded capitalism, the struggle had shifted from people against nature to people against one another. Marx called this type of sustained conflict of one class against another the "class struggle."

Marx believed that increasing numbers of people would be unemployed because capitalists would buy more and more machines to replace workers—doing so in hopes of making greater profits after they no longer had to pay so much in wages. Marx insisted that this trend would result in an ever-widening gulf between the two classes—capitalists and workers. The rich would become richer and the poor would become poorer. The situation would lead to a struggle between the two classes that eventually would destroy capitalism.
Philosophy of socialism. Marx urged the workers to revolt. He said that they should end the capitalist system and replace it with a new system—communism. Marx saw socialism as a step on the road to communism. Under socialism the factors of production would become public property. The government would be a ‘dictatorship of the proletariat.’ This dictatorship of the working class would rule the country. Representatives of the proletariat would make all economic decisions.

Development of communism. According to Marx, the socialist phase of his plan would lead to communism. Marx felt that during the socialist stage the people’s material and spiritual well-being would improve and that eventually a classless society would come into existence. All property would be owned collectively, government would no longer be needed, and all people would work to the best of their abilities and they would consume only what they needed.

SECTION 1 REVIEW

Key Terms
capitalism, socialism, capitalists, proletariat, communism

Reviewing Main Ideas
1. Describe the economic and social ideals of the early socialist thinkers.
2. According to Marx, what caused the inequalities between capitalists and the proletariat?
3. According to Marx, how should economic decisions ideally be made?

Thinking Critically: Identifying Assumptions
An “assumption” is something that people take for granted without having actual proof. List some assumptions that Karl Marx made about capitalism, socialism, communism, or human nature.
2 The Soviet Union practices authoritarian socialism.

In the Soviet Union, the largest country in the world, the system of government and the economy are based on the teachings of Karl Marx. Although the Soviet Union is commonly referred to as a communist nation, many economists describe the Soviet system as authoritarian socialism. It is a system in which a central government makes the basic economic, political, and social decisions. In the political system, one that is closely tied to the economic system, there is a lack of both personal freedom and democratic representation.

Find answers to the following questions when reading about the Soviet economic system:
1. Why did a revolution take place in Russia?
2. What kind of economy has developed in the Soviet Union?
3. What characterizes a command economy?
4. How does the Soviet government attempt to achieve social and economic equality?

Conditions in Russia led to political and economic upheaval.
Karl Marx had predicted in the 1800s that it would be inside industrialized nations, such as Germany or Great Britain, that oppressed, downtrodden factory workers would lead a revolt against the prevailing economic and political system. Instead such a revolution took place in an agricultural country: Russia. In 1917, when the Russian Revolution began, approximately 80% of the people worked and lived on farms. To understand the revolution and the economic and political system that was set up as a result, it is important to understand the conditions under which these Russians had lived during the 1700s and the 1800s.

Between the early 1700s and 1861, most Russian peasants, or serfs, were treated almost as slaves. They worked the farms of rich landowners, and when the land was sold, they were included in the sale. When the czar, the ruler of Russia, freed the serfs in 1861, few received land. Thus, when factories opened in Russian cities in the late 1800s, many peasants left the farms for factory jobs. The peasants found life in the cities no better. Wages were low, and there were shortages of food and other necessities. In 1917 (during World War I), factory workers, farmers, and the army joined together in a revolution intended to end Russia's involvement in the war and to take power from the landowners, factory owners, and government leaders.

The Soviet Union today has developed a command economy.
After the 1917 revolution, one of its leaders, Vladimir Lenin, set up a new government that was based on the system he called communism. The government was a dictatorship. It was made up of members of the Communist party, the only political party that
was allowed to exist. The government claimed control of all business property, housing, and land. People who opposed the government’s actions were killed or were forced to live in prisonlike conditions. An economy in which the government answers the four basic economic questions is a command economy. The Soviet economy is an example of such a system.

In the years immediately following the revolution, the government allowed peasants to continue farming the land. It was the government, however, that decided what would be done with the crops. It usually took most of what the peasants produced. Because many peasants stopped producing as a result of this policy, the government changed its policy for a time. It allowed farmers to sell their food and keep any of their profits.

This return to market economics stimulated food production, but it was contrary to the communists’ long-term economic goals. Thus in 1928 Joseph Stalin, the new leader of the government, retook control from the individual farmers. He announced the first five-year plan for the economy. This central plan emphasized the development of such heavy industries as tractor production and bridge building.

An emphasis on one kind of production means less production in another area. The industrial growth that became the Soviet Union’s top priority led to a shortage of consumer goods. Because they had had so few goods in the past, many Russians welcomed the plan as an opportunity to build for a future in which there would be more...
benefits for everyone. In recent years, Soviet planners have put more emphasis on the production of consumer goods. Nonetheless, shortages of those goods have always typified the Soviet economy. Between the Lines on page 422 discusses the supply and demand of consumer goods.

After a series of rapid leadership changes in the early 1980s, Mikhail Gorbachev came to power in 1984. He inherited an economy that was inefficient and full of corruption. Since taking power, Gorbachev has attempted to solve the nation's economic problems by instituting some economic reforms. However, Gorbachev has not yet made any changes that significantly alter the structure of the Soviet economy—as, for example, allowing manufacturers to produce what they want and to set prices according to market value rather than according to values set by the government. Most experts agree that until more substantive economic changes are made, the Soviet economy will not improve significantly.

**A command economy is characterized by certain features.**

All command economies share certain features. These features are described in the following discussion.

- **Central planning.** Central economic planning is the key to the Soviet economy. Most retail and wholesale stores, the banking system, housing, agriculture, and industry in general are all public property under state control. The government makes five-year plans for the economy. Each plan determines what to produce, how much to produce, how to produce, and how to distribute. Then the state economic planning agency, GOSPLAN, makes production plans to accomplish these goals.
Quotas. Each year’s plan sets quotas, or specific requirements. For example, a shoe factory will be told how many pairs of shoes to produce. Meeting the quota becomes the primary objective of the factory’s manager, who is appointed by the government and is responsible to it for the factory’s output. Considerations such as the quality of the output may be ignored in order to meet the state’s demand for a specific quantity. Usually a factory is given a total quota that includes several different kinds of items. As a result a manager may decide to produce more of one item that is easy to produce or that requires fewer resources. An example of how this happens was described in the introduction to this chapter. Most of the automobile-parts manufacturers in the Soviet Union choose to produce heavy parts.

Prices. The government sets prices for most goods. When a commodity is sold, a tax called a turnover tax is added. This tax does not return to the factory’s managers or workers. The tax provides a large share of the government’s revenues, which it then invests according to its economic plans.

Economic incentives and productivity. Some economists point to a lack of economic incentive as the reason that production often fails to reach the levels planned by the government. As shown in Figure 16-1 below, growth in many areas of the Soviet economy has not reached the targets set by the government’s plans.
The difference in the level of productivity between publicly owned farms in the
Soviet Union and privately owned plots of land supports the conclusion that economic
incentives increase productivity. Most Soviet farm workers live and work on publicly
owned farms. The workers are paid with a share of the money received for the crops at
harvest, or they are paid a fixed wage. In addition, each farm family is allowed a small
plot of land—approximately one acre—for its own use. A family can keep the profit from
any crop that it grows on this private plot. The families work this land only part-time,
after their work on the publicly owned farm is done. Although these private plots
represent about 3% of the country's agricultural land, they produce more than 25% of
the total value of agricultural output. If such high productivity characterized all Soviet

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**Between the Lines**

**Supply and Demand in a Command Economy**

In an authoritarian socialist economy, many economic decisions are based on social or political
goals rather than on profits. Although economic decisions are made outside the marketplace,
people still react according to the laws of demand and supply. Therefore, decisions made by
government can lead to problems for consumers.

- **Supply and demand.** Consider the demand side in a centrally planned economy like that
  of the Soviet Union. Suppose the plan sets a quota of 10,000 bicycles and fixes the price at $150.
  Because both the number of bicycles to be produced and the price of the bicycles is fixed by the
  government, we could picture the supply curve as a vertical line situated at 10,000 bicycles. See
  Figure 16-2 below.

  As far as the consumers are concerned, however, there still is a demand curve. Because they
  are not forced to buy the products, they will still adjust their consumption depending upon the
  price of an item.

- **Shortages or surpluses.** Suppose the fixed price of $150 is below the equilibrium price. Then
  the market would look like Figure 16-2. In this case, a shortage would exist. However, Soviet
  factories cannot respond to the consumers' willingness to pay more for a bicycle.

  Alternatively, suppose that $150 is above the equilibrium price. The market then would look like
  Figure 16-3 below. In this case, a surplus would exist. Production will remain at 10,000 because
  factory workers and managers are paid whether the bicycles sell or not. Unless the planners lower
  the price, the surplus bicycles will remain in stores, unsold.
agriculture, the country would not need to import agricultural products. In fact the Soviet government seemed to acknowledge private incentives in 1985 with a new law that permitted citizens to engage in such small, private businesses as the production of clothing and furniture. The law, in addition to regulations that allowed farmers to sell small amounts of privately produced agricultural goods, represented the first legal restoration of free enterprise to the Soviet economy since the 1920s.

**The Soviet government attempts to provide for the people's welfare.**

Because economic equality and social equality are socialist ideals, it seems reasonable to ask how the Soviet Union has dealt with these goals. To find out, we'll examine the current situation.

- **Housing.** Public housing accounts for some 25% to 30% of the housing available in the Soviet Union. Despite government building programs, however, housing is in short supply. In many city apartments, families share a common kitchen, living room, and bathroom. Many rural people live in small, privately owned, cabin-like structures.

- **Health.** Health care for everyone is provided by the state. Some of the hospitals and doctors in the Soviet Union appear to equal the best medical facilities available anywhere. However, these facilities seem to be limited to the ruling group. The ordinary person can receive free medical treatment, but it is generally of lower quality.

- **Education.** Education at all levels is also provided by the government. After a student completes the first eight years of school, he or she may leave school, move into
a secondary school that is somewhat like U.S. high schools or into one of several types of vocational training schools. The vocational training schools lead to particular jobs. For example, some of these schools train agricultural workers and others train nurses and lab technicians. Only students who have attended secondary school may move on to university studies.

Educational choices are limited in two ways. First, tests that a student takes at the age of 15 determine whether he or she will go on to secondary school or move into one of the specialized training schools. Tests also determine who will be admitted to universities. Second, the governing group's decisions about the need for particular types of workers limits individual choice. If it believes that the country needs engineers, for example, the government will move students in that direction by making funds available for engineering education, while decreasing funds for other areas.

Work and wages

Workers in the Soviet Union are guaranteed a job at a fixed wage rate. Yet to some degree the government applies market incentives in setting wages. In factories, wages often are linked to production through piece rates; that is, workers are paid according to the number of items they produce. This kind of payment works as an economic incentive to increase productivity.

Incentives are also used to increase the supply of workers for certain jobs. Scientists, for example, are in short supply. As a result their wages are higher than those of some other professions. Truck drivers are also in short supply. They are consequently paid more than doctors, of which there is an oversupply.

SECTION 2 REVIEW

Key Terms

Authoritarian socialism, five-year plan, quotas, turnover tax, piece rates

Reviewing Main Ideas

1. What conditions led Russia to adopt a socialist system?
2. What type of economy operates in the Soviet Union? What sort of production have Soviets emphasized in following this economic system?
3. What features are characteristic of a command economy?
4. Use Soviet agriculture to explain the relationship between economic incentives and productivity.
5. Give examples of ways in which the Soviet government attempts to provide for the people's general welfare.

Thinking Critically: Making Decisions

Suppose that you are the manager of a glass factory in the Soviet Union. Your monthly quota of window glass is one million square meters, and you discover that the factory might not meet this quota. What could you do to increase the quantity of glass produced in the factory?
China's socialist economy has undergone some important changes.

With a population of just over one billion, the People's Republic of China accounts for one-fifth of the world's population. Although its history goes back thousands of years, from an economic standpoint China is currently a developing nation.

For much of this century, China isolated itself from the rest of the world. In recent years the Chinese leadership has decided to open the country to the outside world. To understand the magnitude of the economic and social changes that this involves, one must begin by looking at what has happened to China since the end of World War II.

Find answers to the following questions when reading about China's socialist economy:

1. What type of economy did the Chinese adopt during Mao Zedong's early years in power?
2. How did the Cultural Revolution affect the economy?
3. What was the initial area of reform under China's "Four Modernizations"?
4. Besides agriculture, where else in China's economy have reforms been applied?
5. How have economic reforms affected China's consumers?

Under Mao Zedong the Chinese adopted a socialist economy patterned after the Soviet system.

When the Japanese were driven out of China in 1945, civil war had already broken out in China. The struggle for power was between the Kuomintang (gwô'mîn'dîng'), or nationalist, government, led by Chiang Kai-shek (jîâng' kî'shek'), and the Chinese Communist party, led by Mao Zedong (mô' dzô'dông'). Even though the United States and other foreign powers supported the Kuomintang, the tide of the war gradually began to shift in favor of the communists. The high rates of inflation in 1948 and 1949 and the economic problems that accompanied it helped to swing the support of the peasants to the communists. On October 1, 1949, more than three million Chinese jammed Tian An Men (tyên' ân' mun') Square in the heart of Beijing (bô jîng') (Peking) to hear Mao proclaim the founding of the People's Republic of China.

- Rehabilitation. The next three years were a period of rehabilitation. The economic goals of the new government included ridding China of feudalism, imperialism, and bureaucratic capitalism, the chief political goal, establishing a totalitarian regime with all power concentrated in the state. This was done eventually but at a great human cost. Millions who resisted were executed or imprisoned.

- Land reform. For 2,000 years China had practiced a feudalistic system under which the peasants worked the land for the landlords. Under the Land Reform Law of 1950, the land, farm equipment, and farm animals were taken away from the landlords and redistributed to the peasants. The special privileges that foreign businesses had
enjoyed before liberation were abolished. Many foreigners left China because their businesses were no longer profitable. Others left because their businesses were gradually taken over by the state.

- **Conversion to state-run industries.** The term *bureaucratic capitalist* referred to people in the nationalist government who owned businesses. Many of these people had become wealthy monopolists as a result of their high positions in the government. Shortly before liberation many of China's industries, its major banks, the railroads and airlines, and the largest trading companies were controlled by these bureaucratic capitalists. After liberation the communist government confiscated these businesses and converted them to state-owned enterprises. These enterprises quickly became the foundation of the Chinese economy.

- **The first five-year plan.** China's first five-year plan began in 1953. Under the plan the Chinese tried to establish a socialist system that was patterned after the Soviet Union's system. A major emphasis was placed on the development of heavy industry. The planners hoped at some time in the future to modernize other sectors of the Chinese economy, such as agriculture, transportation, and communication. Power plants, coal mines, iron and steel works, and machine factories received most of the state funds that were allocated by the plan. Although the economy fell short of many of the goals set by the plan, the Chinese people could see that some economic progress was being made.

- **The Great Leap Forward.** The moderate successes of the first five-year plan were quickly offset by the many mistakes made during the Great Leap Forward in 1958 and 1959. The goal that was set was to surpass Britain in the production of steel and other important products in 15 years or less. Mao and many high party officials felt that their goals could be accomplished by the force of their own wills and through great efforts by the Chinese people. After all, they thought, mobilizing the masses had been successful in defeating the powerful Kuomintang. It seemed reasonable to expect that the same tactic could work economic miracles as well.

This turned out to be too much to ask of China's technologically and managerially backward economy. Targets for industry were set unrealistically high. For example, steel output and the production of coal and electric power were supposed to double during the two-year period. In agriculture, most of the nation's cooperative farms were merged into large communes. These communes were not only supposed to improve farming but were also supposed to build small industrial plants, schools, and community mess halls. Much of the food that was grown in the countryside was taken to the cities to support the workers who were building new factories. This, combined with bad weather, caused severe food shortages in the countryside, resulting in the starvation of millions of peasants.

All of this resulted from trying to do too much too quickly. As a result, China's economy worsened. The early 1960s were devoted to government attempts to correct the economic mistakes that were made during the Great Leap Forward. To encourage the production of food, peasants were given small plots of land that could be used to grow their own vegetables or other crops.
China's economy suffered under the Cultural Revolution.

The Cultural Revolution, which lasted from May, 1966, until October, 1976, was the next major event in China's economic history. It is a good example of how political struggles for power can adversely affect a nation's economy. The Cultural Revolution began as a movement to rid the Communist party, the army, and the government of the people of whom Mao did not approve. It was also aimed at removing the "reactionary bourgeois" authorities from their positions of control over China's schools and cultural institutions. In essence it pitted the peasants and workers against the educated class in China.

In July, 1968, workers' "Propaganda Teams" took charge of the nation's schools and cultural institutions. In the past a system of entrance examinations had been used in China's educational system. Under the new system, local party leaders recommended workers, peasants, and soldiers for admission to the nation's schools. Many of the educated people in China were demoted to menial jobs or were sent out into the countryside to work for the farmers. It was not unusual for schools and universities to be closed.

China's economy suffered many setbacks during this period of social upheaval. The average-per-capita amount of major goods such as grain, pork, and cotton cloth available were slightly less in 1976 than they were in 1966. In the cities the average-per-capita housing space had shrunk to 3.6 square meters. In the early 1950s, this figure
had been 4.5 square meters. When the Cultural Revolution ended in 1976, China faced the task of reviving its economy.

The “Four Modernizations” began with agricultural reforms.

December, 1978, marked the beginning of far-reaching reforms for the Chinese economy. The reforms focused on modernizing China’s agriculture, industry, science, and defense. The Chinese commonly refer to these reforms as the “Four Modernizations.” Deng Xiaoping (deng shiou-ping) is considered the key Chinese leader behind these reforms. Deng feels that the reforms are the basis of the new socialism with Chinese characteristics that is currently emerging in China. Many of the economic changes that are occurring are designed to open China's economy to the world.

Supplying food for the Chinese people is important to the success of the “Four Modernizations.” That is why agriculture was chosen as the sector of the economy with which to begin the reforms. Because 80% of the people live outside of the cities in China, the economic charges in agriculture involve most of China’s population.

Under the commune system of the past, the state decided which crops would be grown. The food grown on the communes was turned over to the state to be sold in state stores. Members of the commune earned work points based upon the number of hours worked and the type of work done. They then used these points to buy the things that they needed. This system was designed using the socialist principle of “to each according to his work.” The work points that were earned, however, bore no relationship to the quality of or to the size of the crop that was eventually harvested. Thus there was little incentive to work hard and to be productive.

The new responsibility system is designed to provide peasants with incentives to be productive. Although the land is still publicly owned, each household is assigned a section of land. The peasants choose which crops they want to grow, contract with the government to produce a certain quota, and are allowed to keep anything that they produce in excess of the quota. This excess can then be sold in free markets in which prices are determined by market forces rather than being set by the state.

**Successes.** The tea growers of the Shuang Feng (shwang fung) Tea Production Brigade are one example of what has happened under the responsibility system. In 1978 families in the brigade averaged 860 yuan (yuen) (less than $300) a year. By 1984 their income was 2,700 yuan ($900). The increased income came from an improvement in the quality of the tea that they produced. This is how one local woman explains it:

Before the new system, when everyone made the same money no matter how hard or little they worked, because it was easier to pick large leaves than small ones, people used to wait for the leaves to grow before they picked them, and we produced relatively low-quality tea. Now everyone wants to pick early and often, maybe 30 times a year instead of six or seven. So the weight of the tea is about the same, but the quality is first class.

Lou Yumin (lo yu'min) explains the responsibility system this way:

And, under the old policy, good workers and lazy ones were paid the same. Why make any special effort? The present system is better. This year we have been allowed to sell
our vegetables independently if we like, and we're all happy about this. In the past I never bothered to plan my work or figure out how to do it better. I just did whatever our brigade leaders ordered. Now I think about everything—what we should grow, when to apply fertilizer, when to harvest—and so on.

China's new responsibility system has been accompanied by the development of free markets in which the peasants are allowed to sell their products. In 1985, $20 billion worth of products were sold in China's free markets. In Hebei (hu'bi') Province, for example, free markets accounted for 81% of the lamb sold, 57% of the beef, 68% of the eggs, and 66% of the vegetables.

**Problems.** The success of the responsibility system has not been achieved without some problems. Some farmers increased their incomes dramatically during the early 1980s. This is contrary to the socialistic idea that everyone should earn approximately the same income. Not only has this caused strife between richer and poorer farmers, but city workers also began complaining that their state fixed incomes had not kept pace with the more successful farmers.

In 1985 the production of rice and other food grains declined, after five years of steady increases. The price of these staple food items had been kept low by the government while the farmers' expenses for fertilizer and farm equipment had risen. As a result, farmers had switched to more profitable crops, such as vegetables. Fearing food shortages, in 1986 the government reimposed quotas on farmers for rice and certain other grains.

This was a step backward from the responsibility system. Some farmers even claimed that they never really had an opportunity to decide which crops they wanted to plant. Situations like these make it difficult to determine how extensively the economic reforms have been incorporated into China's economic system.

**Economic reforms have been applied to industry.**

In the past, all businesses were part of what the Chinese call the "iron rice bowl" system. The state planners would establish the goals for each factory. The manager's...
job was merely to carry out the orders for higher units of production. Revenues that were earned were put into one large pool, and the state distributed it to the firms in accordance with the priorities it had set. In such a system, an individual firm was not held accountable for its own profits or losses. Fulfilling the plan was the only criteria used for judging success. Bankruptcy was an impossibility. Encouraged by the success of the responsibility system in agriculture, China’s leaders decided to apply similar principles to industry. In early 1986 a plan was drafted that would begin to make the managers of factories and businesses responsible for profits and losses. It will be late in the 1980s, however, before businesses will be held fully accountable for their profits and losses under the responsibility system.

Despite these reforms, however, Chinese workers continue to share in the “iron rice bowl” system through guaranteed lifetime employment. After a person is assigned to a work unit, he or she cannot be fired. The work unit provides each worker with a place to live, a small monthly salary, and subsidized health care. Great efforts are taken to make sure that the incomes of workers remain approximately the same. This provides workers with very little incentive to work hard and be productive.

**Consumers have benefited from economic reforms.**

Although the state owns most urban housing, an effort to supply a small amount of private housing began in 1985. In Beijing and Shanghai (shànghàn), for example, a few apartments were sold to private individuals. Owners were not allowed to resell the apartment, however, to someone else. In Beijing a two-room apartment with a kitchen
and bathroom costs approximately 5,000 yuan. To put this cost into proper perspective, the average city worker received 80 yuan a month.

For Chinese consumers the reforms have meant an increase in the variety of goods and services available. Planners are allowing clothing to be more colorful and stylish. This is quite a change from the blue and green Mao coats that most of the Chinese wore as recently as the early 1980s. A new, “open-door” policy has also allowed consumer products from Japan, Hong Kong, and other nations into China. As a result, Chinese consumers are able to choose from a much greater selection of goods from around the world than the goods that are available to Soviet consumers.

Will the reforms last? No one can know with absolute certainty. If the reforms are successful, it will mean transferring the power that the large bureaucracy and the Chinese Communist party have over the economy to the managers of factories and individuals in society. Critics are skeptical that this transfer of power will take place smoothly. Some in China want to strengthen the teaching of Marxism and return to the old ways. They feel that the costs of opening China to foreign influences far outweigh any benefits that can be gained. Economic problems are bound to accompany the changes involved in the reforms. In the mid-1980s, for example, inflation was beginning to reappear in China. This greatly concerned those people who could remember the hyperinflation of the late 1940s under the Kuomintang. Most people agree, however, that the longer the reforms remain in place, the more difficult it will be for Deng’s opponents to turn China’s economy back to the state control of the past.

SECTION 3 REVIEW

Key Terms
peasants, feudalistic system, bureaucratic capitalist, Great Leap Forward, Cultural Revolution, responsibility system, “iron rice bowl”

Reviewing Main Ideas
1. Describe the basic economic goals established under Mao Zedong.
2. Why did the Cultural Revolution have a negative effect on China’s economy?
3. How did the reforms under the “Four Modernizations” change the agricultural system in China?
4. What successes have occurred as a result of agricultural reforms? What problems have developed?
5. Describe some ways in which industry has changed under recent economic reforms.
6. Describe how economic reforms have affected China’s consumers.

Thinking Critically: Analyzing Comparisons
Do you imagine that you would be more in favor of China’s new economic reforms if you were the owner of a small farm in one of China’s rural areas or if you were a factory worker in one of China’s largest cities? Explain your answer.
4 Britain's economy is a combination of socialism and capitalism.

Some economists have classified the economies of Britain, Sweden, Denmark, and West Germany as socialist. Although there are elements of socialism in the economies of these countries, they also include many capitalist elements. To one degree or another, of course, every economy is a mixture of different systems.

In each of these nations, the people have chosen leaders through a system of representative democracy. At times they have elected leaders who support socialist economic policies. At other times they have elected leaders who have capitalist goals. The shift from one policy to another has resulted in an economy that is mixed. A look at the economy of Britain provides an example of such a mixture.

Find answers to the following questions when reading about the British economy:
1. What are the basic goals of British socialism under the Labour Party?
2. What economic policies has the Conservative Party supported?

British socialists in the Labour Party emphasize the general welfare of all citizens.

British socialists, beginning with Robert Owen, have suggested changes that they felt could improve the living and working conditions of the British people. These early British socialists wanted to eliminate social injustice and raise the general standard of living. The goal they saw as the end result of such improvements was a welfare state. In other words, they wanted economic decisions to be made with the general welfare, rather than self-interest, in mind. Although the British socialists shared some of the beliefs of Marxist socialists, they worked to bring about socialism gradually, through changing laws, rather than by overthrowing the government.

- Welfare laws. The Old Age Pensions Act of 1908 signaled the beginning of socialist policies in England. Under this act, all people more than 70 years of age gained the right to a pension. The next major step toward socialism in Great Britain was the passage of the National Insurance Act of 1911. This act provided for retirement pensions, free medical treatment, and unemployment income. In July, 1948, the National Health Service took responsibility for the nation's medical care. The government would provide medical care for all British citizens without regard to the patient's ability to pay.

- Industry. In July, 1945, the Labour Party came to power in Britain. Its leaders wanted to broaden the application of socialist economic ideals. World War II, which ended that year, had destroyed many of Britain's industrial plants. Even before the war, many of those plants had become outdated and inefficient. With Labour Party leadership, then, the government began to rebuild Britain's industrial sector.
In keeping with the principles of socialism, the Labour government nationalized many of the major industries and services in Britain. The government paid private owners for the industries and businesses and took charge of their operations. These nationalized industries and services included coal, steel, iron, transportation, communications, and some banks.

By taking control of these industries, the Labour Party argued that it would protect both consumers and workers from being exploited by private monopolies that might develop under capitalism. Through these nationalized industries, the government planned capital investment programs that were designed to help the economy grow. Meanwhile, small businesses and agriculture remained in private ownership. Thus, capitalism remained part of the British economic system. Although the government controlled some sections of the economy, the people could change the degree of the government's economic control by electing new leaders.

The British Conservative Party supports certain capitalistic economic policies.

When British citizens elect a new government, they also choose the economic policy of the party that they elect. In 1978 the voters faced a choice between the Labour Party, which supported continued socialist economic policies, and the Conservative Party, which regularly criticized socialist policies in two major areas.

- Labor. One area of Conservative criticism has been labor. For the most part, labor unions are very strong in those industries controlled by the British government.

Miners strike in Britain under the watchful eyes of police. When there is a strike in the nationalized coal industry, no coal is produced in the nation.
When the unions go on strike for higher wages, the strikes can disrupt the entire economy. For example, when coal workers go on strike, no coal is produced because all coal workers have one employer—the government. When such a strike occurs, there is a great deal of pressure on the government to settle the strikes quickly. These increased costs of production (higher wages) have been passed on to consumers—either directly in the form of higher prices or indirectly through government subsidies to the affected industries.

**Balancing the budget.** Conservatives have also pointed out that the increasing costs of social-welfare programs have made it difficult to balance the national budget. By the early 1970s, the difference between government expenditures and tax revenues was so great that the government increased the money supply in order to meet its obligations. As a result of this increase, the Conservatives said, the inflation rate rose drastically—passing 27% by 1975.

In 1978 British voters elected the Conservative Party. The new Prime Minister, Margaret Thatcher, had campaigned against socialism. She wanted to return several important industries to the private sector. She also wanted to reduce government spending and the programs designed to redistribute income. Her election represented, in part, a choice by the British voters for a move toward capitalism.

Today, there is considerable disagreement about how successful Mrs. Thatcher has been in running Britain's economy. Inflation has been reduced, but the level of unemployment remains high. Although Prime Minister Thatcher managed to break a major strike by British coal miners, she has made little progress in returning important industries to the private sector.

In the future, British voters may support Conservative Party or Labour Party policies. Because they can elect parties that represent different economic policies, they can continue to mix socialism and capitalism. Whether they continue their move toward capitalism, or move again toward socialism, cannot be predicted with accuracy.

### Section 4 Review

**Key Terms**

- welfare state
- nationalize

**Reviewing Main Ideas**

1. Give two examples of socialist economic policies under the Labour Party in Britain.
2. In what ways has the Conservative Party in Britain supported capitalist policies?
3. Explain two criticisms that the Conservatives have made about the economic policies of the Labour Party in Britain.

**Thinking Critically: Assessing Cause and Effect**

What do you think caused the British to choose the Labour Party's socialist policies after World War II, but to support the Conservatives' free-market policies in the 1980s?
Comparing Prices and Wages

In this Skill Workshop, you will compare the prices of goods in various nations. Such an activity can indicate not only the prices of goods, but also the kinds of goods that are being produced in each country. Therefore, in this activity, you will compare the price of goods in five cities: Washington, D.C., for the United States; London for Britain; Moscow for the Soviet Union; Paris for France; and Munich for West Germany.

Computing Prices in Terms of Work.

Prices stated in the currencies of different nations would be difficult to compare. Thus, in 1982 the National Federation of Independent Businessmen (NFIB) Research and Education Foundation funded a study that compared the work time needed by the average manufacturing worker to purchase certain items in each of the five cities mentioned earlier.

In December, 1981, the hourly take-home pay (in dollars) of workers in these cities was $5.69 for American (U.S.) workers, $4.13 for British (U.K.) workers, $4.66 for French workers, $5.00 for West German workers and $1.35 for Russian (U.S.S.R.) workers. These wages were used to convert, or translate, prices into work time. For example, a $1.52 loaf of bread would cost an American worker .267 hours of work time (.152 + .569 = .267 hours of work time). This amounted to 16 minutes of work time (.267 x 60 = 16 minutes of work time).

Applying Your Skills.

1. Suppose a bar of soap costs 55¢ in the United States, 1.4 pounds in Britain, and 32 rubles in the Soviet Union. From this information alone, can you tell in which country soap is the most expensive? What could be done to make comparisons possible?

2. Suppose a record album in Paris costs $4.45 (U.S. dollars). What is the work-time price of the album for the average French worker?

3. If an average U.S. worker wanted to take a trip that costs $500, how many hours would he or she have to work to earn the cost of the vacation?

4. How much time would an average Soviet worker have to work to buy a watch that costs $50?

Comparing Prices.

Table 16-1 on page 436 includes some of the information from the 1982 NFIB study. You should remember that the list includes goods that may be in greater supply or demand in one country than they are in another. Also, the goods may not be of the same quality.

Applying Your Skills.

5. What is the work-time price of the following items in the United States, Britain, and the Soviet Union: hamburger meat, jeans, men's shoes, refrigerator, automobile?

6. How much longer does a worker in Munich work to buy milk than a worker in the United States? To buy a lipstick?

7. How much longer does an American worker work to buy a refrigerator than a British worker does? How much longer than the American does a Soviet worker work to buy the refrigerator?

The Weekly Food Basket.

The weekly food basket is a combination of foods that an average family of four might eat each week.
The 1982 study set up a list of 23 commodities for the basket—items that would be available in each country. The list included the first eight items in Table 16-1 below, plus such things as flour, noodles, beef, pork, cabbage, carrots, tomatoes, and tea.

Applying Your Skills.
8. Which country’s worker had to work the longest to buy the basket?
9. Which item in the basket added most to the cost for that worker?

Comparing Economies.
There is, of course, more to a country’s economy than the cost of goods. Table 16-2 on page 437 includes figures for other elements of the five nations’ economies, based on 1982 data.

Applying Your Skills.
10. Which of the five countries has the largest civilian labor force?
11. Summarize your view of the economic situation in each country, based on Tables 16-1 below and 16-2 at right.

### Table 16-1 COMPARATIVE STANDARD OF LIVING

This table shows the approximate work time required for an average manufacturing employee to buy selected commodities in retail stores in Washington, D.C., London, Paris, and Munich at state-fixed prices in Moscow during March, 1982.

<table>
<thead>
<tr>
<th>Commodity</th>
<th>Washington</th>
<th>Moscow</th>
<th>London</th>
<th>Paris</th>
<th>Munich</th>
</tr>
</thead>
<tbody>
<tr>
<td>Milk (1 liter)</td>
<td>6 m.</td>
<td>22 m.</td>
<td>9 m.</td>
<td>8 m.</td>
<td>7 m.</td>
</tr>
<tr>
<td>Hamburger meat, beef (1 kg)</td>
<td>37 m.</td>
<td>123 m.</td>
<td>63 m.</td>
<td>80 m.</td>
<td>70 m.</td>
</tr>
<tr>
<td>Sausages (1 kg)</td>
<td>33 m.</td>
<td>160 m.</td>
<td>51 m.</td>
<td>75 m.</td>
<td>75 m.</td>
</tr>
<tr>
<td>Potatoes (1 kg)</td>
<td>7 m.</td>
<td>7 m.</td>
<td>3 m.</td>
<td>4 m.</td>
<td>4 m.</td>
</tr>
<tr>
<td>Apples, eating (1 kg)</td>
<td>10 m.</td>
<td>52 m.</td>
<td>23 m.</td>
<td>15 m.</td>
<td>15 m.</td>
</tr>
<tr>
<td>Sugar (1 kg)</td>
<td>9 m.</td>
<td>58 m.</td>
<td>11 m.</td>
<td>9 m.</td>
<td>10 m.</td>
</tr>
<tr>
<td>Bread (1 kg)</td>
<td>16 m.</td>
<td>17 m.</td>
<td>16 m.</td>
<td>18 m.</td>
<td>27 m.</td>
</tr>
<tr>
<td>Eggs (10)</td>
<td>8 m.</td>
<td>55 m.</td>
<td>16 m.</td>
<td>13 m.</td>
<td>12 m.</td>
</tr>
<tr>
<td>Weekly fixed basket for family of four</td>
<td>18.6 h.</td>
<td>53.5 h.</td>
<td>24.7 h.</td>
<td>22.2 h.</td>
<td>23.3 h.</td>
</tr>
<tr>
<td>Soap, small bar (150 grams)</td>
<td>4 m.</td>
<td>20 m.</td>
<td>5 m.</td>
<td>7 m.</td>
<td>6 m.</td>
</tr>
<tr>
<td>Lipstick</td>
<td>30 m.</td>
<td>69 m.</td>
<td>60 m.</td>
<td>76 m.</td>
<td>60 m.</td>
</tr>
<tr>
<td>Panty hose</td>
<td>18 m.</td>
<td>366 m.</td>
<td>18 m.</td>
<td>17 m.</td>
<td>18 m.</td>
</tr>
<tr>
<td>Jeans</td>
<td>3 h.</td>
<td>40 h.</td>
<td>6 h.</td>
<td>6 h.</td>
<td>7 h.</td>
</tr>
<tr>
<td>Men’s shoes</td>
<td>8 h.</td>
<td>25 h.</td>
<td>7 h.</td>
<td>7 h.</td>
<td>5 h.</td>
</tr>
<tr>
<td>Refrigerator, cheapest</td>
<td>44 h.</td>
<td>155 h.</td>
<td>40 h.</td>
<td>53 h.</td>
<td>42 h.</td>
</tr>
<tr>
<td>Color TV set (36 cm screen)</td>
<td>65 h.</td>
<td>701 h.</td>
<td>132 h.</td>
<td>106 h.</td>
<td>143 h.</td>
</tr>
<tr>
<td>Small car</td>
<td>5 mon.</td>
<td>53 mon.</td>
<td>11 mon.</td>
<td>8 mon.</td>
<td>6 mon.</td>
</tr>
<tr>
<td></td>
<td>United States</td>
<td>France</td>
<td>West Germany</td>
<td>Britain</td>
<td>Soviet Union</td>
</tr>
<tr>
<td>---------------------------</td>
<td>---------------</td>
<td>--------</td>
<td>-------------</td>
<td>---------</td>
<td>--------------</td>
</tr>
<tr>
<td>Gross National Product</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Billion 1982 US $</td>
<td>3,050.3</td>
<td>538.8</td>
<td>656.6</td>
<td>468.6</td>
<td>1,715.0</td>
</tr>
<tr>
<td>Percent Real Growth</td>
<td>-1.7</td>
<td>1.7</td>
<td>-1.1</td>
<td>1.2</td>
<td>2.0</td>
</tr>
<tr>
<td>Per capita (1982 US $)</td>
<td>13,180</td>
<td>9,940</td>
<td>10,650</td>
<td>8,360</td>
<td>6,350</td>
</tr>
<tr>
<td>Government Final Consumption as a % of GNP</td>
<td>18.1%¹</td>
<td>15.8%¹</td>
<td>20.7%¹</td>
<td>24.3%¹</td>
<td>75.3%¹</td>
</tr>
<tr>
<td>Defense Expenditures as a % of GNP</td>
<td>5.0%²</td>
<td>4.0%²</td>
<td>3.3%²</td>
<td>5.1%²</td>
<td>N.A.³</td>
</tr>
<tr>
<td>Population/Area</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Million Persons at Midyear</td>
<td>232.1</td>
<td>54.4</td>
<td>61.6</td>
<td>55.0</td>
<td>270.0</td>
</tr>
<tr>
<td>Area (km²)</td>
<td>9,362,123</td>
<td>547,026</td>
<td>248,577</td>
<td>244,046</td>
<td>22,402,200</td>
</tr>
<tr>
<td>Labor</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Labor Force (millions)</td>
<td>111.87</td>
<td>23.50</td>
<td>27.18</td>
<td>25.94</td>
<td>149.22</td>
</tr>
<tr>
<td>Agricultural Labor Force (millions)</td>
<td>3.57</td>
<td>1.60</td>
<td>1.37</td>
<td>N.A.³</td>
<td>31.13</td>
</tr>
<tr>
<td>Industrial Employment (millions)</td>
<td>27.07</td>
<td>7.21⁴</td>
<td>10.48⁴</td>
<td>8.03⁴</td>
<td>37.55</td>
</tr>
<tr>
<td>Production</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Electricity (billion kilowatt-hours)</td>
<td>2,387</td>
<td>258</td>
<td>362</td>
<td>272</td>
<td>1,366</td>
</tr>
<tr>
<td>Crude Steel (million metric tons)</td>
<td>65.7</td>
<td>18.4</td>
<td>35.9</td>
<td>13.8</td>
<td>147.0</td>
</tr>
<tr>
<td>Trade</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Exports (billion US $)</td>
<td>212.3</td>
<td>96.7</td>
<td>176.4</td>
<td>97.0</td>
<td>87.2</td>
</tr>
<tr>
<td>Imports (billion US $)</td>
<td>254.9</td>
<td>115.7</td>
<td>155.4</td>
<td>99.6</td>
<td>77.8</td>
</tr>
<tr>
<td>Transportation</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Railroad Freight</td>
<td>1,175.0</td>
<td>61.0</td>
<td>57.7</td>
<td>15.9</td>
<td>3,464.4</td>
</tr>
<tr>
<td>(billion metric ton-kilometers)</td>
<td>4,738</td>
<td>3,286</td>
<td>2,315</td>
<td>27,672²</td>
<td>26.7⁴</td>
</tr>
<tr>
<td>Rail Passenger Kilometers</td>
<td>1,475²</td>
<td>4,738</td>
<td>3,286</td>
<td>2,315</td>
<td>27,672²</td>
</tr>
<tr>
<td>Monthly Average (millions)</td>
<td>414.9</td>
<td>37.3</td>
<td>N.A.³</td>
<td>50.8</td>
<td>172.5</td>
</tr>
<tr>
<td>Air Passengers</td>
<td>537</td>
<td>357²</td>
<td>377²</td>
<td>276²</td>
<td>31²</td>
</tr>
<tr>
<td>(billion passenger-kilometers)</td>
<td>58³</td>
<td>27³</td>
<td>32³</td>
<td>26³</td>
<td>32³</td>
</tr>
<tr>
<td>Air Freight</td>
<td>9,500</td>
<td>2,303</td>
<td>1,068</td>
<td>1,350</td>
<td>3,400</td>
</tr>
<tr>
<td>(million metric ton-kilometers)</td>
<td>791⁵</td>
<td>414³</td>
<td>434⁴</td>
<td>477³</td>
<td>84⁴</td>
</tr>
<tr>
<td>Indicators of Living Standards</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Grain Production (kilograms per capita)</td>
<td>1,461</td>
<td>882</td>
<td>400</td>
<td>389</td>
<td>712²</td>
</tr>
<tr>
<td>Meat Production (kilograms per capita)</td>
<td>103</td>
<td>99</td>
<td>72</td>
<td>51</td>
<td>56</td>
</tr>
<tr>
<td>Automobile Registrations (units per thousand persons)</td>
<td>537</td>
<td>357²</td>
<td>377²</td>
<td>276²</td>
<td>31²</td>
</tr>
<tr>
<td>Energy Consumption (barrels oil equivalent per capita)</td>
<td>58³</td>
<td>27³</td>
<td>32³</td>
<td>26³</td>
<td>32³</td>
</tr>
<tr>
<td>Telephones in Use (units per thousand persons)</td>
<td>791⁵</td>
<td>414³</td>
<td>434⁴</td>
<td>477³</td>
<td>84⁴</td>
</tr>
<tr>
<td>Life Expectancy (years)</td>
<td>73</td>
<td>74</td>
<td>72</td>
<td>71</td>
<td>69</td>
</tr>
<tr>
<td>Education</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Primary Teachers (thousands)</td>
<td>1,330</td>
<td>232</td>
<td>273</td>
<td>275</td>
<td>2,325</td>
</tr>
<tr>
<td>Primary Students (thousands)</td>
<td>25,852</td>
<td>4,651</td>
<td>5,354</td>
<td>5,327</td>
<td>33,576</td>
</tr>
<tr>
<td>Secondary Teachers (thousands)</td>
<td>1,130</td>
<td>364</td>
<td>287</td>
<td>N.A.³</td>
<td>N.A.³</td>
</tr>
<tr>
<td>Secondary Students (thousands)</td>
<td>20,342</td>
<td>5,008</td>
<td>4,243</td>
<td>N.A.³</td>
<td>10,217</td>
</tr>
</tbody>
</table>

¹1981  ²1980  ³N.A. = not available  ⁴excluding Dept. of Defense shipments  ⁵1979  Source: World Bank, 1982 data

AVS 3A. Reaching Have students compare the ways in which market and command economies respond to shortages. How does this affect the daily lives of people living under those economic systems?

AVS 3A. Enrichment Have students debate articles about daily life in China, the Soviet Union, and Britain. Have them each write a diary of a teenager living in one of those nations.
CHAPTER 16

REVIEW

SECTION SUMMARY

1 Socialism is based on the idea of equality.
Early socialists felt that the factors of production should be owned in common and that income should be distributed equally. At the basis of communism are Marx's beliefs that capitalism would be destroyed by conflict between capitalists and workers, that under communism all property would be owned collectively, and that government would be unnecessary.

2 The Soviet Union practices authoritarian socialism.
In the economic system in the Soviet Union, called authoritarian socialism, the economy is controlled by the central government. Soviet economic planners create five-year plans, which designate quotas to be met by factory managers.

3 China's socialist economy has undergone some important changes.
Under Mao Zedong, China's economic system resembled the Soviet Union's command economy. In 1978 economic reforms gave peasants incentives to be more efficient and productive. Some Chinese feel that the reforms conflict with the socialist ideal that everyone should receive the same income. Under the "iron rice bowl" system, firms are not held accountable for their profits and losses and workers are guaranteed lifetime employment.

4 Britain's economy is a combination of socialism and capitalism.
Under the welfare state that has evolved in Britain in the twentieth century, the government provides for the welfare of its citizens with such programs as social security, unemployment insurance, and free medical care. The Labour Party followed many socialist policies, such as nationalizing major industries. The Conservative Party criticized the Labour Party for allowing unions to become too strong and for creating large budget deficits.

USING ECONOMIC SKILLS

Activities
1. Interview someone who has lived in another country. Find out about the economic and social conditions in that country. Compare what you learn with the findings of others in the class.

2. As a class decide upon a representative weekly basket of food for a family of four. Then visit local stores to find the cost of this basket of food. Divide that cost by the minimum wage in order to find out how much it would cost someone who is making that wage in terms of work time.

Bibliography:

Reading Source Material
1. Read "Socialized Care" in The Wall Street Journal, February 9, 1983. List two major problems of the National Health Service in Britain.

Reviewing the Skill Workshop
Table 16-3 at the right lists the amount of work time required for an average manufacturing employee to purchase various items in 1982 in Washington, D.C., and in Moscow.
1. What was the work-time price of milk in Washington? In Moscow?
2. How much longer did a Soviet worker have to work to buy a small car than an American worker?
3. What do the dramatic differences in work time needed to buy such consumer items as lipstick and cars suggest about the differences between the U.S. and Soviet economies?

<table>
<thead>
<tr>
<th>Commodity</th>
<th>Washington</th>
<th>Moscow</th>
</tr>
</thead>
<tbody>
<tr>
<td>Milk (1 liter)</td>
<td>6 m.</td>
<td>22 m.</td>
</tr>
<tr>
<td>Potatoes (1 kg)</td>
<td>7 m.</td>
<td>7 m.</td>
</tr>
<tr>
<td>Lipstick</td>
<td>30 m.</td>
<td>69 m.</td>
</tr>
<tr>
<td>Small car</td>
<td>5 m.</td>
<td>53 m.</td>
</tr>
</tbody>
</table>

m. = minutes    mon. = months

TESTING FOR UNDERSTANDING

Knowing Key Terms
Define these terms in your own words.

Section 1
- capitalism
- socialism
- capitalists
- proletariat
- communism

Section 2
- authoritarian socialism
- five-year plan
- quotas
- turnover tax

Section 3
- piece rates
- peasants
- feudalistic system
- bureaucratic capitalist
- Great Leap Forward
- Cultural Revolution
- responsibility system
- "iron rice bowl"

Section 4
- welfare state
- nationalize

Reviewing Main Ideas

Section 1
1. What are the three main characteristics of socialism?
2. What did Marx predict would happen to capitalism? Why?

Section 2
1. Explain why some Russian peasants might have been sympathetic to communist doctrines.
2. Describe production emphasis under the Soviet Union's command economy.
3. What features characterize a command economy?

Section 3
1. What type of economy did Mao Zedong introduce in the early years of the People's Republic of China?
2. Why did the Cultural Revolution have negative effects on China's economy?
3. How have incentives for farmers changed agricultural production in China?
4. What are factory managers responsible for under China's new urban reforms?
5. How do Chinese consumers benefit from economic reforms?

Section 4
1. What are the main goals of British socialists under the Labour Party?
2. How do British Conservatives disagree with the Labour Party?

Thinking Critically
1. Assessing Cause and Effect. What factors led to the rise of socialist economic systems in some countries? easy
2. Identifying Assumptions. Will the United States ever adopt a socialist economic system? Give three reasons. challenging

Answers to Knowing Key Terms:
See margin definitions in Chapter 16.

Answers to Reviewing Main Ideas:
The questions under Reviewing Main Ideas cover the main ideas introduced in the Reading Previews and reviewed in the Section Reviews of this chapter. For answers to these questions, see the appropriate Section Review.

Answers to Thinking Critically:
CON 3A 1. Student answers will vary but should include low wages, food shortages, and poor housing conditions.
CON 3A 2. Student answers will vary but should note differences between capitalism and socialism.